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Global Macro 360

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Weekly Note – Looking to the West

12-May-2017

Good Morning,

It's been an eventful week across the Atlantic following Trump's decision to pull one out of the Nixonian playbook and fire FBI Director, James Comey — and if he can go after the FBI, what's to stop him from going after the Fed? Bearing this in mind, let's touch base with the US economic outlook.

Last week's United States ISM and employment prints confirm that the earlier downside surprises in Q1 GDP and March payrolls probably don't mean much in the grand scheme of things. The paltry Q1 GDP increase of just 0.7% will likely be revised higher, but even if this happens we still see a strong rebound in Q2.

TABLE 1 THIS WEEK IN MARKETS

Name	YTD %	MTD %	WTD %
DOW JONES	5.97%	0.01%	-0.07%
S&P 500	7.18%	0.65%	0.48%
RUSSELL 2000	3.13%	-0.06%	0.62%
NASDAQ COMPOSITE	13.86%	1.35%	0.93%
Euro Stoxx 50	10.68%	2.31%	0.38%
FTSE 100	3.41%	2.54%	1.91%
DAX 30	11.16%	2.61%	0.90%
NIKKEI 225	4.43%	3.98%	3.37%
HANG SENG	14.20%	2.07%	1.79%
S&P/ASX 200	3.75%	-0.77%	0.03%
EUR-USD X-RATE	3.40%	-0.18%	-1.00%
EUR-GBP X-RATE	1.30%	-0.15%	0.88%
Gold Spot $/Oz	6.42%	-3.72%	-0.57%
Crude Oil	-10.76%	-2.82%	5.32%

The 211,000 jobs gain in April confirms our initial assessment that the revised 79,000 number in March was a weather-related hiccup and not the start of a more fundamental deterioration. Our estimate of the current jobs trend remains 175,000, twice the breakeven rate needed to keep the unemployment rate stable. Accordingly, the labour market continues to tighten apace. The unemployment rate is now down to 4.4% — a tenth below the FOMC's year-end forecast and three-tenths below the committee's estimate of the structural rate.

The broader underemployment rate (U6) is down to 8.6%, a level last seen in November 2007, just before the start of the Great Recession. The employment/population is back to pre-recession levels once we adjust for population aging and the structural downward trend among prime-age males. Furthermore, the net percentage of households rating jobs as *"plentiful"* vs. *"hard to get"* remains around the highest levels since 2001.

The financial market response to Friday's strong employment numbers was relatively muted because of revisions to average hourly earnings, which pushed the year-on-year rate down to 2.5%. But this indicator, while noteworthy, probably deserves less weight than it usually receives in financial markets. However, despite the strength in the labour market, the March CPI and PCE numbers revealed unexpected weakness on the other side of the Fed's dual mandate. This continues to suggest that the Federal Reserve will tighten policy at a gradual pace.

But gradual does not mean glacial, and the pace of hikes currently priced into the bond market — just four more 25bps hikes through the end of 2019 — still seems much too low to us. Even if core inflation remains below target for longer than anticipated, we think Fed officials would try to bring about a tightening in financial conditions in order to stop the downward trend in the unemployment rate before too long. This is consistent with the Fed's behaviour in the late 1990s, when the conflicting signals from the two sides of the dual mandate — with core inflation muted, but unemployment ticking further and further below the staff's NAIRU estimate — were resolved in favour of a funds rate that ultimately rose to 6.5%. Once again, we think Fed officials will not want to take the risk of letting the unemployment rate fall to a level that is so low that a subsequent sizable increase looks inevitable. After all, the US economy has never seen an increase in the unemployment rate of more than 0.35% without a recession.

Following Friday's employment numbers, we lifted our probability of a hike at the June FOMC meeting to 90%. There are still some important indicators to be released, including another round of employment and PCE numbers, but it seems highly unlikely that these would be sufficiently weak to dissuade the committee from another move. They will, however, be important for the dot plot. We doubt that the 2017 median would move up from the current projection of two more hikes given the likelihood of balance sheet adjustment later this year, but a steepening in the 2018 median from the current three hikes is possible if the data are strong.